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TREASURY ALSO PASS FEDERAL RESERVE
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SUBJECT: THE AUSTRIAN ECONOMY - STATUS AND POLICY OUTLOOK IN LIGHT
OF CURRENT GOVERNMENT COALITION NEGOTIATIONS

Summary

¶1. (SBU) The Austrian National Bank (ANB) and the International Monetary Fund (IMF) have recently presented positive analyses of the Austrian economy and the impact of reforms over the last five years. However, both the ANB and IMF recommend that Austria should continue to focus on macroeconomic stability, balancing the budget, implementing structural and administrative reforms, and reorienting education and innovation policies towards a knowledge-based economy. These medium- and long-term policy prescriptions, necessary to maintain Austria's competitiveness in the global economy, do not appear to have priority in the current negotiations between the Social Democrats (SPO) and the People's Party (OVP) toward forming a Grand Coalition. Many of the SPO's proposed economic and fiscal measures would worsen the budget deficit and reverse many of the previous government's reforms, such as, pension reform. End Summary.

Sound Policies Yield Good Economic Performance
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¶2. (U) Austria's economy continues to perform well, with most of its economic indicators exceeding Euro area averages: 3.3% growth in 2006 and 2.8% in 2007; an unemployment rate of 4.7-4.9%; and a total public sector deficit of approximately 1.3-1.7% of GDP in 2006.

¶3. (U) Austria has implemented an impressive string of important structural reforms over the last 5 years -- pension reform, corporate and personal income tax cuts, and tangible efforts to balance the budget. The IMF's 2006 report on Article IV consultations characterized Austria's recent economic performance as among the best in the Euro area and commended the GoA for its sound economic policies and wide-ranging structural reforms. Austria has also benefited enormously from globalization, and in particular from the opening of markets of the 10 new EU members and to other countries in Central and Southeastern Europe. According to Austrian National Bank (ANB) Director Peter Zoellner, "Austria is an actor in globalization and not one of its victims."

But Economists See Room For Improvement

¶4. (U) Despite the recent impressive economic numbers, many economists believe Austria still suffers from over-regulation and overdependence on the public sector. Bernhard Felderer, Director of

the Institute for Advanced Studies (IHS), and ANB Governor Klaus Liebscher have publicly called on the GoA to concentrate more on balancing the budget, and implementing administrative and labor market reforms. Building on successful structural reforms will be vital to position Austria better for the challenges and opportunities of globalization.

The IMF's Conclusions

¶5. (U) On December 11, IMF Mission Chief Paul Hilbers presented the preliminary conclusions of the IMF's Article IV consultations with Austria. The IMF paper confirms that reforms have been key for Austria's economic success in recent years. However, the IMF recommends a continued focus on macroeconomic stability and structural reforms. In particular, the IMF paper notes that balancing the budget by 2008 should remain a primary GoA objective. Implementing a viable administrative reform, which would streamline functions among the various levels of government, is imperative for the GoA to reduce budget expenditures, the paper argues. Health care reform and reform of the elderly care systems should also be important policy goals of the GoA. According to Hilbers, the time is propitious for further reforms, as the Austrian economy is at the top of its current growth cycle.

The Longer Term Perspective

¶6. (U) A recent White Paper of the Austrian Institute for Economic Research (WIFO) outlines strategies for Austria to achieve stronger growth and higher employment through innovation. The paper argues that the GoA should give more attention to innovation as a vehicle

to further improve Austria's international competitiveness and as a source to finance the welfare and health systems of an ageing society. According to WIFO, a standstill on reforms would cause Austria's economy to fall back over time. WIFO lists a number of policy areas in which the GoA should concentrate more: improving the education and training systems; closing the gaps in infrastructure, particularly in transportation networks between Austria and the new EU Member States; promoting enhanced competition and flexibility in labor and product markets; and implementing administrative reform.

Comment -- The Reality of Politics Trumps Economics

¶7. (SBU) The policy prescriptions outlined above present an excellent medium- and long-term guideline for the Austrian economy to maintain its competitive position in a dynamic global setting. However, in the current negotiations between the Social Democratic Party (SPO) and the People's Party (OVP) to form a Grand Coalition, both parties appear to have an eye on short-term fixes with a view to the next elections. The OVP, while advocating continued reforms, has been put on the defensive by the populist SPO campaign promises to roll back many of the OVP's economic and fiscal policies. Chief among these are SPO calls to revisit the 2000-2005 pension reforms, to introduce to a basic social allowance for "those in need," and reverse favorable corporate tax treatment for Austrian investors overseas. Most analysts reckon that the minimal basket of SPO economic and fiscal measures would entail an additional Euro 1.5 billion in expenditures. Without corresponding increases in revenue, this increased spending would raise the projected 2007 deficit by at least 0.5 percentage points to 1.5-2.1% of GDP.

¶8. (SBU) Most analysts argue that a resumption of the approach that prevailed from the 1960 to the 1990s --continually expanding the social benefits system, at the expense of budget deficits and a rising federal debt --would be counterproductive. In the end, Austria remains a high tax country, with social expenditures representing 29% of GDP.